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Report to the Chairman, Subcommittee on Oversight and Investigations, Committee on Merchant Marine and Fisheries, House of Representatives

May 1989

CUSTOMS SERVICE

Administration of Tariff on Foreign Repairs to United States Flag Vessels





United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

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May 26, 1989

The Honorable Thomas M. Foglietta
Chairman, Subcommittee on Oversight
and Investigations
Committee on Merchant Marine
and Fisheries
House of Representatives

Dear Mr. Chairman:

Your June 2, 1988, letter expressed concern that the existing 50-percent tariff on the cost of repairs made in foreign shipyards to U.S.-flag vessels¹ may not be effective in achieving its objective of protecting and preserving the U.S. shipyard repair capability for national defense purposes. You noted that the U.S. shipbuilding and repair industry has experienced unprecedented decline over the past decade. Because of your concern, we agreed to determine:

- How much revenue has been raised by this tariff in recent years?
- How have U.S. Customs Service interpretations of legislative and court exemptions affected the scope and application of the tariff?
- What assurances are there that companies are paying all tariffs that they owe and what efforts has Customs Service made to improve its management of the vessel repair tariff?

Results in Brief

U.S. Customs Service reports show that collections have generally increased from about \$700,000 in fiscal year 1969 to \$14.6 million in fiscal year 1988. Collections in the 1980s have averaged \$8.6 million as compared with an average of \$1.9 million collected in the 1970s. (See app. I, pp. 8 to 10.)

Customs believes that the effects of (1) legislative exemptions of specific categories of repair work, (2) court rulings narrowing the definition of the term "repair," and (3) the logical extensions of these legislative exemptions and court rulings by Customs have reduced the applicability of the vessel repair tariff. Customs has not computed the dollar effect of exemptions on the tariff collections. To determine some relative dollar value for the exemptions, we reviewed 67 cases decided in 1988 in

¹Vessels registered under the laws of the United States.

which about 48.5 percent, or \$7.1 million, of the potential duty was not collectable because of the exemptions. (See app. I, pp. 11 to 13.)

While prior Customs audits of vessel operators have been limited, they have found no significant instances of failure to report foreign repairs. However, Customs has identified areas in its administration of the vessel repair tariff where better management and control are needed. Because Customs is currently clarifying operational procedures and increasing the audit surveillance of vessel operators to ensure complete and accurate reporting of foreign repairs, we are not making any recommendations. (See app. I, pp. 13 to 15.)

Background

To protect the U.S. shipyard repair capability for national defense purposes, Customs is authorized to levy a 50-percent tariff on the cost of repairs made to U.S.-flag vessels in foreign shipyards. The 50-percent tariff was first enacted in 1866 (14 Stat. 183-4). The tariff was imposed on U.S.-flag vessels engaged in domestic or foreign trade with Canada, but relief from duties was provided for vessels compelled to seek foreign repairs because of weather-related or other casualties. The Tariff Act of 1922 (P.L. 67-318) expanded the scope of dutiable repairs to include repairs to all U.S.-flag vessels engaged in foreign trade anywhere in the world.

The Tariff Act of 1930 (19 U.S.C. 1466) included major revisions that provided additional exclusions to the 50-percent tariff. For example, previously, only foreign repairs made to ensure the safety of the vessel met the criterion for exemption from duty, but the 1930 act broadened the exemption to include repairs necessary for seaworthiness of the vessel. Also, in 1971 and again in 1984, the tariff was revised by the Congress to exempt certain types of vessels and repairs from duty.

In fiscal year 1988, the Customs Service had 9,045,969 entries for all commodities and services brought into the United States of which 1,054, or about 0.01 percent, were vessel repair entries. In this same period, the Customs Service collected duties of \$15.8 billion of which the vessel repair duty was \$14.6 million, or about 0.09 percent, of the duties collected. As these statistics show, the vessel repair tariff is a small part of Customs' duty collections.

Vessel Repair Tariff Collections

Vessel repair tariff collections have increased during the last 20 years from about \$700,000 in fiscal year 1969 to \$14.6 million in fiscal year 1988. Even when adjusted for inflation, collections have increased. In constant 1969 dollars, the average annual collection in the 1980s was \$3.2 million compared with \$1.4 million in the 1970s. Neither Customs nor a number of other agencies we contacted maintained data on the total value of repairs performed on U.S.-flag vessels in foreign shipyards.

Certain Repairs Exempted From the Tariff

Although Customs believes the present statute continues to provide considerable protection to U.S. shipyards' repair capabilities, it believes that the degree of protection has decreased because legislative amendments and court interpretations have resulted in an increase in the number of exemptions. For example, legislative amendments exempted repairs necessary for the safety and seaworthiness of the vessel, while a court decision exempted drydocking expenses while the vessel is undergoing repairs.

Our review of the legislative and judicial history of the vessel repair tariff shows that, since the Tariff Act of 1922, the duty provisions have been substantively changed. Some of these amendments were the subject of significant court decisions interpreting the tariff's application. The result, in effect, has been the exemption of various types of expenses from the coverage of duty. To determine some value for the exemptions, we requested Customs to provide us with data concerning all 169 vessel repair tariff cases reviewed by Customs Headquarters in calendar year 1988. However, only 67 cases had been decided. In these 67 cases, about 48.5 percent of the duty that might have been imposed on the value of foreign repairs, or \$7.1 million of potential duty, was not collectable because of the various exemptions.

Compliance With Vessel Repair Tariff

Limited Customs audits of the vessel operators have found no significant instances of failure to report foreign repairs. Since 1984, Customs has completed five audits of four vessel operators. The audits found that the vessel operators generally reported foreign repairs. The audits did question the timeliness of the operators' submission of supporting information and classification of some cost as nondutiable. However, a management review by Customs officials noted inconsistent application of the vessel repair tariff operating procedures and lax controls by Customs personnel. Customs is currently clarifying operational procedures

and increasing the audit surveillance to assure compliance with the vessel tariff requirements.

Scope and Methodology

Our work was conducted between July 1988 and March 1989 at U.S. Customs Service headquarters in Washington, D.C., and at the Vessel Repair Liquidation Unit located in New Orleans, Louisiana. We interviewed officials of the Customs Service, Maritime Administration, Coast Guard, Internal Revenue Service, the Commission on Merchant Marine and Defense, and trade associations representing ship operators and shipbuilders to obtain information on foreign repairs to U.S.-flag vessels. Further, we reviewed files and records and obtained data from the Customs Service relating to the entry and liquidation of foreign repairs to U.S.-flag vessels. We also reviewed all of the legislative provisions concerning the tariff on foreign ship repairs, beginning with the original provisions in the 1866 act as well as related legislative histories, relevant court interpretations, and Customs' regulations implementing the tariff.

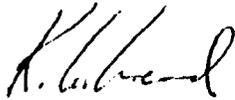
In addition, to develop some information on the monetary effects of tariff exemptions, at our request, Customs provided information on its decisions on all applications for relief from duty made during 1988 (169 entries).

We discussed the information in this report with Customs Service officials, and they agreed with the facts. However, as you requested, we did not obtain official agency comments on a draft of this report. Our review was conducted in accordance with generally accepted government auditing standards.

As arranged with your office, unless you publicly announce its contents earlier, we plan no distribution of this report until 15 days from the date of this letter. At that time, we will send copies to the Commissioner of the Customs Service; the Administrator, Maritime Administration; and

other interested congressional committees. Copies will also be provided to other interested parties upon request. Major contributors to this report are listed in appendix II.

Sincerely yours,



Kenneth M. Mead
Director, Transportation Issues

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Abbreviations

CFR	Code of Federal Regulations
GAO	General Accounting Office
GNP	gross national product
MarAd	Maritime Administration
P.L.	Public Law
Stat.	Statute
U.S.C.	United States Code

Administration of Vessel Tariff Program

Customs regulations¹ require the owner or master (vessel operator) of a U.S.-flag vessel arriving at its first U.S. port to declare all repairs and equipment purchases made in a foreign port. The declaration of entry² is required regardless of the dutiable status of the expenses. The Customs district office responsible for the port forwards the vessel repair tariff entry to one of three Vessel Repair Liquidation Units,³ which reviews documentation for completeness and determines the duty. After determination of duty, the information is returned to the district for billing the vessel operator.

Vessel Repair Tariff Collections

Vessel repair tariff collections increased from about \$700,000 in fiscal year 1969 to \$14.6 million in fiscal year 1988. While the 1988 collections were unusually high compared with other years—nearly twice as much as in 1987—there was an increase in the average annual vessel repair tariff collections in the 1980s over the 1970s. The average in the 1980s was \$8.6 million compared with an average of \$1.9 million in the 1970s. In constant 1969 dollars, the average annual collection in the 1980s was \$3.2 million compared with \$1.4 million in the 1970s. Table I.1 shows, for the 20 fiscal years through 1988, the tariff collections, the collections in constant 1969 dollars, and the number of vessel repair entries.

¹Customs vessel repair tariff regulations are contained in 19 CFR Chap. 1, Sec. 4.14.

²Entries are the filings or declarations by importers—in this case the vessel operators—declaring the commodities or services they are bringing into the United States.

³Customs has established three Vessel Repair Liquidation Units to handle all vessel repair entries for the nation: New Orleans, New York, and San Francisco.

**Appendix I
Administration of Vessel Tariff Program**

Table I.1: Vessel Repair Statistics

Fiscal years	Vessel repair duties collected	Duties in constant 1969 dollars^a	Number of vessel repair entries
1969	\$695,874	\$695,874	^c
1970	1,490,066	1,412,015	^c
1971	1,827,205	1,637,900	^c
1972	2,789,345	2,387,439	955
1973	1,082,265	870,185	1,029
1974	1,727,193	1,273,005	1,079
1975	1,796,698	1,205,878	1,048
1976	2,017,637	1,272,614	1,096
1977	1,929,471	1,141,054	1,043
1978	2,237,716	1,233,533	2,479
1979	2,195,672	1,111,803	2,142
1980	2,821,094	1,310,146	1,995
1981 ^b	7,490,397	3,171,466	2,120
1982 ^b	11,958,332	4,759,416	2,172
1983	9,856,261	3,775,546	2,216
1984	9,816,598	3,627,675	1,437
1985	5,398,984	1,937,598	1,172
1986	8,617,922	3,011,355	1,204
1987	7,118,547	2,407,121	938
1988 ^b	14,576,465	4,780,569	1,054

^aInformation to derive constant dollar figures was taken from the implicit price deflator for GNP. (Source: Department of Commerce, Bureau of Economic Analysis.) The 1988 deflator is an estimate.

^bCustoms explained that the large increases in these years were due to major repairs made to several vessels.

^cInformation on the number of vessel entries not available.

Source: U.S. Customs Service.

Table I.1 also shows that the number of entries, after peaking in 1978, has declined to previous levels whereas the duty collection has remained relatively high in the 1980s.

Officials from the Maritime Administration (MarAd), the U.S. agency responsible for promoting the merchant marine industry, and trade associations of shipowners and shipbuilders informed us of several factors that could explain the 1980s increase in the duty collected on repair work in foreign shipyards. Some of the factors include the following:

- Foreign shipyards are generally much less expensive than U.S. shipyards. Therefore, more repairs are being performed overseas, even though the operator has to pay the additional 50-percent tariff.

- MarAd has a program which provides an operating subsidy to U.S. operators to offset certain lower costs of foreign competitors. In the late 1970s, MarAd eliminated, for most vessels, the maintenance and repair portion of the subsidy which was available if repairs were made in U.S. shipyards. Without the maintenance and repair subsidy, operators had less incentive to obtain maintenance and repair work in the United States instead of the less expensive overseas shipyards.
- In the 1980s, 36 U.S.-flag vessels with diesel engines were built in foreign shipyards. Operators of these vessels would more likely repair the diesel engines in foreign shipyards, where workers are more familiar with diesel engines.
- The U.S. fleet, although declining in the number of vessels, is requiring more maintenance as it ages; therefore, as more repairs are required—and obtained overseas because of lower repair costs—the value of repair work per ship in foreign shipyards most likely will increase.

Although Customs has tabulated the total value of dutiable repairs, it has not tabulated the total value of all foreign repairs. Customs officials advised us that Customs does not maintain a record of total foreign repairs because (1) the data on total foreign repairs are not needed to manage the tariff program, (2) the total dollar value of foreign repairs is usually not available when vessels first arrive in port, and (3) only the amount of foreign repairs remaining after the determination of exempted amounts is needed to determine the duty.

We also attempted to determine if the value of foreign shipyard repairs could be obtained from MarAd and the Internal Revenue Service. Officials in each agency advised us that they did not need the data and therefore did not maintain them. The data were likewise unavailable from the Commission on Merchant Marine and Defense⁴ and the trade associations of ship operators and shipbuilders.

⁴The Commission on Merchant Marine and Defense was established by P.L. 98-525 on October 19, 1984, to study problems relating to the U.S. merchant marine industry, including the shipyards, and to make recommendations it considered appropriate to foster and maintain the industry to meet the naval and merchant ship needs in time of war or national emergency.

Statutory Amendments With Their Court Interpretations Exempted Certain Expenses From the Tariff

Although Customs believes the present statute continues to provide considerable protection of U.S. shipyards' repair capabilities, it believes that legislative amendments and court interpretations have reduced the applicability of the tariff from that intended by the 1930 act. Customs was unable to provide an estimate of the monetary effect of legislative and judicial actions because it has not made such an evaluation and has not accumulated the data necessary for an evaluation.

Changes in Scope of Tariff

The Commission on Merchant Marine and Defense, asserting that the tariff no longer appeared to function as intended under the original legislation, asked Customs to (1) identify the causes for the decline in the tariff's effectiveness and (2) suggest how the existing law or implementing regulations could be improved or changed to restore the original intent of the tariff.

In response, Customs provided an extensive historical account of the enactment, implementation, and modification of the tariff. In Customs' opinion, the underlying intent of the vessel repair statute has remained intact, and domestic repair facilities have remained the intended beneficiaries of the law. However, Customs said the degree of protection which is afforded has decreased because legislative amendments, judicial limitations, and agency interpretations have resulted in an increase of the number of exemptions. For example, the following costs are exempt because of legislation:

- Repairs to all vessels, regardless of their purpose, remaining outside the United States for a period of 2 years, except for those repairs occurring during the first 6 months after departure.
- Repairs necessary for the safety and seaworthiness of the vessel.
- Repairs for a damaged vessel when the damage is due to some extraordinary event, i.e., "stress of weather or other casualty."

In addition, the following are exemptions established after court decisions:

- The drydocking expenses while the vessel is undergoing repairs.
- The cost of inspections, if such inspections do not result in repairs being made.
- Charges for transportation of materials.

Although Customs did not advocate legislative action, it stated that a return to a more broadly protective statute would require legislative action to place currently exempted foreign vessel repair costs under the tariff. Our review of the legislative and judicial history of the vessel repair tariff indicates that Customs' examples of the changes that have taken place over the years is accurate with respect to exemptions of specific expenses from the coverage of the tariff.

Monetary Effects of Legislation or Judicial Opinions Are Not Determined by Customs

We were unable to determine to what extent legislative changes, including those interpreted by the courts, have reduced the degree of protection afforded by the original tariff because Customs does not maintain the necessary data to develop such an estimate. Customs did not estimate the monetary effects of legislation or judicial opinions at the time it provided responses to the Commission.

However, to develop some information on the monetary effects of the exemptions, at our request, Customs provided information on its applications for relief⁵ from duty made during 1988 (169 entries). The information showed that of the 169 entries, duty had been decided on 67. For these 67 entries, over \$14 million worth of foreign repairs had been excluded from duty. As a result, about \$7.1 million, that is 48.5 percent of the duty the Congress might have imposed on foreign repairs, was not collectable because the Congress had exempted these foreign repairs from the tariff.

Table I.2: Duty Determination on 67 Entries Considered for Relief of Duties

Declared value of foreign repairs	\$29,386,519	
Potential duty ^a		\$14,693,259
Repairs determined to be dutiable	15,132,478	
Duty ^b		7,566,239
Differences:		
Repairs excluded from duty	\$14,254,041	
Potential duty lost to exemptions		\$7,127,020

^aPotential duty is 50 percent of declared total value of foreign repairs.

^bThe duty is 50 percent of the dutiable foreign repairs.

Source: U.S. Customs Service.

⁵A vessel operator has 60 days from the date of arrival to apply for relief, i.e., claim a remission or refund if the operator believes that the foreign costs are not dutiable.

Since duty determinations by Customs' liquidation units were still pending on the remaining 102 entries, we were not able to determine the effect of exemptions and/or Customs interpretations on all of the entries considered for relief in 1988.

Customs Administration of Vessel Repair Tariff

Prior Customs audits concerning vessel repair entry and liquidation have reported general compliance with statutory requirements by vessel operators. A management review by a Customs official, however, noted inconsistent application of the operating procedures and lax controls by Customs personnel.

Limited Audit Activity Shows Operator Compliance

Two audit organizations⁶ are responsible for reviewing a broad range of Customs activities. However, because of the relatively small amount of the vessel repair tariff collections compared with tariff revenue collections for other commodities, the vessel repair tariff program is not a major part of Customs' overall audit efforts. Vessel repair tariff audits are performed upon request from Customs officials. Since 1984, Customs has completed five audits of vessel operators. The audits, that included reviews of the records of four vessel operators, found that the operators generally reported foreign vessel repairs. The audits, however, did question the timeliness of the operators' submission of supporting information and classification of some costs as nondutiable. Although two of the five audits showed some understatement of duty liability, none of the five reported failure to declare. The entries related to the understatements were reprocessed accurately during the course of the audits.

Customs attributed the small number of audits of vessel repair activities to national audit priorities. Officials told us that national audit plans in recent years have not included regularly scheduled audits of vessel repair activity because of other areas of emphasis (primarily drug enforcement), limited resources, and the relatively small volume and value of vessel repairs.

However, Customs began reevaluating audit needs for the vessel repair tariff in 1987 because of management interest in improving regulatory audit's role. A comprehensive audit currently in progress of another

⁶The Office of Inspector General, Department of the Treasury (which includes the former Customs Service Office of Internal Affairs), and the Customs Regulatory Audit Division, which makes external audits of Customs entry filers.

ship operator has raised questions concerning the nondeclaration of foreign repairs and the classification of expenses as nondutiable. In addition to the audit currently in progress, the Regulatory Audit Division has assigned a vessel repair audit specialist to plan and coordinate vessel repair audits. Customs will determine the level of future audits on the basis of recommendations from the specialist.

Management Review of Vessel Repair Tariff Procedures

After assuming office in 1988, the Chief of the Carrier Rulings Branch visited Customs' various districts and ports around the country to review activities related to vessel repair entries. According to the Chief, there was a "lack of uniformity" in administering vessel repair procedures. For example, examination of vessel logs, which ensures that information on vessel repairs made in foreign shipyards was obtained from vessel operators and accurately processed by Customs, was not always made. In addition, the Chief found that varying degrees of knowledge and understanding of the vessel repair procedures by Customs personnel had led to inconsistent interpretations and compliance. For example, at one port, the vessel operators' declarations of foreign repairs were not being forwarded to the district office because personnel were unfamiliar with operating procedures. In these cases, Customs liquidation units were not aware that the filings existed and therefore, the vessel operators would not be billed for the duty.

The Chief attributed these problems, in a large measure, to a general lack of management controls, that is, no mechanism to oversee implementation of vessel repair procedures. He noted that vessel repair activities had not been a major priority with Customs and, therefore, had not received as much management attention as other national issues, such as drug enforcement.

On the basis of recommendations made by the Chief, Customs is currently placing renewed emphasis on administering vessel repair operations to ensure compliance with procedural requirements and collection of revenue. Specific training with actual declaration forms, entries, etc., was given to personnel responsible for the vessel repair process in 1988. During this training, procedural steps, such as the spot-checking of vessel logs to ensure compliance with procedures, are being reemphasized.

Presently, a draft Customs directive that would establish uniform guidelines for national application of vessel-repair-operating procedures is under review. Customs officials described the new directive as a clarification of responsibility and reemphasis of regulatory requirements but

were not able to specify when it would be issued. Implementation of the proposed procedures, in the opinion of the Chief, would eliminate local variations in procedures which had developed because of differences in shipping activities and staffing. Because Customs is establishing guidelines to ensure compliance with vessel repair tariff requirements, and specific training has been provided, we are not making any recommendations at this time.

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